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No. 306

In the Supreme Court of the United States

OCTOBER TERM, 1957

THE COLONY, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT

J. LEE RANKIN,
Solicitor General,
CHARLES K. RICE,
Assistant Attorney General,
ROBERT N. ANDERSON,
GRANT W. WIPRUD,
Attorneys,
Department of Justice, Washington 25, D. C.

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OPINIONS BELOW

The opinion of the Court of Appeals (Pet. 15–16) is reported at 244 F. 2d 75. The opinion of the Tax Court (Pet. 17–46) is reported at 26 T. C. 30.

JURISDICTION

The judgment of the Court of Appeals was entered on April 22, 1957 (Pet. 15.) The petition for a writ of certiorari was filed on July 22, 1957. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTION PRESENTED

Is the five-year period of limitations provided by Section 275 (c) of the Internal Revenue Code of 1939 applicable where the understatement of gross income

by more than 25 per cent results from an overstatement of the basis of the property sold?

STATUTE INVOLVED

Internal Revenue Code of 1939:

SEC. 275. PERIOD OF LIMITATION UPON ASSESSMENT AND COLLECTION.

Except as provided in section 276—

* * * * *

(c) *Omission from Gross Income.*—If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 5 years after the return was filed.

* * * * *

(26 U. S. C. 1952 ed., Sec. 275.)

STATEMENT

The material facts are not in dispute. As found by the Tax Court (Pet. 19–33), they may be summarized as follows:

Taxpayer is a corporation dealing in real estate. (Pet. 19.) In 1945 taxpayer acquired certain land for the purpose of subdivision and sale. It sold lots from this property in the taxable years ended October 31, 1946, 1947 and 1950. In computing its gain from these sales for tax purposes, taxpayer used a cost basis which included certain items of alleged development expense which the Commissioner thereafter determined were not properly includible. The principal item disallowed was the expense of constructing a

water supply system, which totaled more than $33,000. (Pet. 24–25.) The Tax Court sustained the Commissioner as to this item, and variously excluded or reinstated certain other items which the Commissioner had excluded from basis. In sum, the Tax Court found that the total amount of development costs includible in taxpayer's basis for the lots in question was $53,702.09, rather than $93,074.61, the figure which taxpayer had included in the basis as estimated development expense in its returns for the tax years ended October 31, 1946, 1947 and 1950. (Pet. 29–32.)

Under these findings of the Tax Court, taxpayer had understated its gross income for the tax years ended October 31, 1946, and 1947 by more than 25 per cent. The deficiency notices for these tax years were mailed within the extended period provided in waivers which taxpayer executed more than three years but less than five years after the returns were filed. (Pet. 32–33.) The Tax Court held that the five-year period of limitations contained in Section 275 (c) of the Internal Revenue Code of 1939 was applicable, and that the assessment of the deficiencies for the years 1946 and 1947 was not barred. (Pet. 45–46.) The Court of Appeals, in a *per curiam* opinion, affirmed. (Pet. 15–16.)

DISCUSSION

1. Section 275 (c) of the 1939 Code, *supra*, p. 2, provides a five-year[1] period of limitations within which the Commissioner may assess a tax, or commence a proceeding in court for the collection of such

[1] The general period of limitations is three years. 26 U. S. C. 275 (a).

tax, where, for the tax year involved, the "taxpayer *omits from gross income* an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return * * *." (Italics supplied.) "Gross income" is defined in Section 22 (a) of the 1939 Code (26 U. S. C. 1952 ed., Sec. 22 (a)) to include "gains, profits, and income derived from * * * sales or dealings in property, whether real or personal" and "gains or profits and income derived from any source whatever." It is the Commissioner's position that the language of Section 275 (c) is clear and unambiguous, and that this section is applicable in terms whenever a taxpayer understates "gross income" by more than 25 per cent.

The case at bar involves income from the sale of lots. Gains from the sale of realty are, of course, includible in "gross income" as defined by Section 22 (a). But it is not the gross proceeds which are includible. Section 111 (a) of the 1939 Code (26 U. S. C. 1952 ed., Sec. 111 (a)) provides that when "gain" is derived from the sale of property, it shall be the excess of the amount realized therefrom over the basis of the property as determined under Section 113 (26 U. S. C. 1952 ed., Sec. 113). Thus, it is only the gross proceeds *less* the basis which constitute "gain" and which are includible as such in "gross income." It follows that where, as in the case at bar, a taxpayer overstates basis by more than 25 per cent in reporting gains from the sale of property, the result is an understatement of "gross income" by more than 25 per cent, and the requirements of Section 275 (c) are met.

The Tax Court has accepted the Commissioner's contention that the five-year period of limitations of

Section 275 (c) is applicable in these circumstances. *Estate of J. W. Gibbs, Sr.*, 21 T. C. 443; *John E. Goodenow*, 25 T. C. 1. The Sixth Circuit reached this same result in *Reis* v. *Commisisoner*, 142 F. 2d 900, and has now followed that decision in the case at bar. We believe that this line of authority is sound.

2. However, as expressly noted in the Sixth Circuit's opinion herein (Pet. 16), there are conflicting decisions in other circuits. In *Uptegrove Lumber Co.* v. *Commissioner*, 204 F. 2d 570, and *Deakman-Wells Co.* v. *Commissioner*, 213 F. 2d 894, the Third Circuit has taken the position that Section 275 (c) does not apply, even though "gross income" be understated by more than 25 per cent, if such understatement results from overstatement of the cost of goods (or basis of property) sold. In effect, these decisions hold that under Section 275 (c) the language "omits from gross income" refers to a failure to report gross receipts. More particularly, the Third Circuit takes the view (which we believe is erroneous) that the Congressional purpose in enacting Section 275 (c) was to confine the statute to situations where taxpayers have failed to make a full disclosure, somewhere in their returns, of the fact and amount of gross receipts.

This view that Section 275 (c) does not apply where there is full disclosure of gross receipts, somewhere in a taxpayer's return, has been adopted and applied by other courts to reach results which are in conflict, directly or in principle, with the Sixth Circuit's decisions in *Reis* and in the case at bar. *Goodenow* v. *Commissioner*, 238 F. 2d 20 (C. A. 8th); *Slaff* v.

Commissioner, 220 F. 2d 65 (C. A. 9th); *Davis* v. *Hightower*, 230 F. 2d 549 (C. A. 5th); *Lazarus* v. *United States*, 142 F. Supp. 897 (C. Cls.).

3. The Internal Revenue Code of 1954 has rendered moot, as to tax years covered by the new Code, the questions here presented. (See Section 6501 (e) (1) (A) (26 U. S. C. 1952 ed., Supp. II, Sec. 6501 (e)). But Section 275 (c) remains the governing statute for two tax years (1952 and 1953) which are still open or for which many cases are now pending. In the Tax Court alone, 121 cases involving $4,948,000 are still pending which require interpretation of the language, "omits from gross income," as used in Section 275 (c). There are also pending in the Internal Revenue Service 69 contested claims (involving $3,750,000) which present the same question, and many of these will doubtless reach the courts. It appears, therefore, that the issue presented as to the proper scope of Section 275 (c) remains one of substantial importance in the administration of the income tax laws.

CONCLUSION

For the reasons stated, the Government does not oppose the granting of certiorari.

Respectfully submitted.

J. LEE RANKIN,
Solicitor General.
CHARLES K. RICE,
Assistant Attorney General.
ROBERT N. ANDERSON,
GRANT W. WIPRUD,
Attorneys.

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